BANK OF ENGLAND

Agents' summary of business conditions

May 2012

- Consumer demand had grown a little in recent months.
- Activity in the housing market continued to rise.
- Private sector investment intentions pointed to a small increase in capital spending over the coming year.
- Goods export growth remained strong, particularly to emerging market economies.
- Turnover in business services had improved a little compared with a year earlier, partly due to higher prices.
- Manufacturing output for the domestic market continued to expand at a moderate pace.
- There had been a further contraction in construction output, in large part due to declining work for the public sector.
- For firms with strong balance sheets, credit was normally available on reasonable terms. But for some businesses there had been a rise in the interest rate spreads charged on loans over the past few months, and fees were also reported to have increased.
- Private sector employment was expected to be broadly unchanged over the next six months.
- In manufacturing, capacity utilisation was a little below normal, with most firms able to meet expected changes in demand comfortably. There tended to be relatively more slack in the service sector.
- Labour cost growth remained fairly modest, and there were generally few signs of upward pressure on pay from employees.
- Input cost inflation remained around its historical average. But the Agents' score had edged up, as past increases in the price of oil fed through to a range of materials, and rising production costs abroad pushed up on import prices.
- Manufacturing output prices continued to rise at a moderate pace reflecting some pass-through of increases in costs. Business services inflation was subdued, but had picked up a little.
- Consumer price inflation remained elevated.

This publication is a summary of monthly reports compiled by the Bank of England's Agents following discussions with contacts in the period between late March 2012 and late April 2012.
It provides information on the state of business conditions from companies across all sectors of the economy. The report does not represent the Bank's own views, nor does it represent the views of any particular company or region. The Bank's Monetary Policy Committee uses the intelligence provided by the Agents, in conjunction with information from other sources, to assist its understanding and assessment of current economic conditions.
A copy of this publication can be found at:
www.bankofengland.co.uk/publications/Pages/agentssummary/default.aspx.

The Bank of England has Agencies for Central Southern England, the East Midlands, Greater London, the North East, the North West, Northern Ireland, Scotland, the South East & East Anglia, the South West, Wales, the West Midlands & Oxfordshire, and Yorkshire & the Humber.

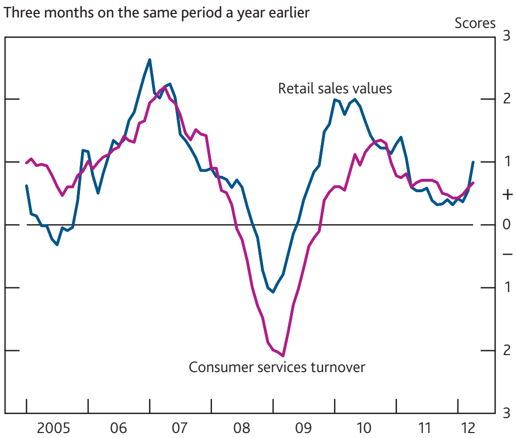
The Bank's assessment of current monetary and economic conditions, and the outlook for inflation, are contained in the Inflation Report, obtained from:
www.bankofengland.co.uk/publications/Pages/inflationreport/default.aspx.

Demand

Consumption

Consumer demand had grown a little in recent months (**Chart 1**). That was partly due to warm weather early in the spring, supporting sales of clothing and garden furniture, for instance. And there had been a slight pickup in spending in household goods, including carpets and cupboards, possibly related to an increase in activity in the housing market. There had also been a sharp rise in private car registrations, thought to be related to a number of factors, including growing demand for small, fuel-efficient vehicles, and improved availability of finance. Spending on food remained resilient. Demand for consumer services was growing at a slower rate than for goods, but there had been an increase in demand for tourism and leisure activities.

Chart 1 Spending on retail goods and services



Despite some signs of improvement, however, for many contacts in retail goods and services the environment remained difficult. Shoppers were still focused on obtaining value for money, and discounting was vital to drive volume growth. There had been an ongoing weakening in brand loyalty, with consumers often visiting several stores to find the lowest price. And online retail continued to gain market share at the expense of the high street, where further insolvencies were expected. Some shopping centres reported a rise in numbers of empty premises, and there were concerns that this could start a cycle of lower footfall and further closures. Similar worries were expressed about the high street.

Housing market

Activity in the housing market continued to rise. That was thought to reflect a number of factors: a rise in the availability of mortgages at high loan-to-values; passage of time having allowed some would-be buyers to save up for a deposit; and the growing prevalence of financial assistance from family members. Buy-to-let demand also continued to strengthen, although the supply of rental property was now catching up with demand in some areas. Vendors were also thought to have become more realistic about selling prices.

Business investment

Private sector investment intentions pointed to further modest increases in capital spending over the coming year. In both manufacturing and services, investment was often motivated by the need to replace worn-out equipment, and to find efficiencies, particularly through greater use of IT. Spending on product development also continued apace. This was often used to reduce the quality or quantity of inputs, in order to lower the cost per unit, or to create new products, which could command a higher price. Some exporters were also increasing capacity to meet rising foreign demand.

Across sectors, many firms had put plans on hold towards the end of 2011, in light of heightened uncertainty about the outlook. While some of these projects were now being taken forward, in other cases, contacts had lowered their expectations for growth, and revised investment plans downward accordingly. And some capital spending remained on hold in the energy sector while contacts waited for more information on government policy.

Exports

Goods export growth remained strong, particularly to emerging market economies. For instance, suppliers of construction materials and equipment were benefiting from the growth of the energy sector and infrastructure development in the Middle East, while producers of luxury goods were seeing rising demand from Russia and the Far East. Professional services, such as architects and engineering advisory companies, also reported strong export growth, reflecting the mix of investment spending overseas. And accountancy and law firms were often involved in corporate transactions in other countries, due to the widespread use of UK law abroad. Across sectors, large and, increasingly, smaller businesses, were looking to foreign markets in order to expand. And in some instances, contacts reported that they were now declining relatively low margin work for the domestic market, in favour of more profitable overseas business.

Output

Business services

The rate of growth of turnover in business services had accelerated a little in recent months, partly due to an increase in prices. Cost-cutting efforts across the economy were generating demand for the services of outsourcing companies, although providers of some low value-added ancillary services, such as cleaning, had been squeezed as their business customers tried to economise. Leasing businesses had seen activity rise as corporates opted to rent equipment rather than buy it themselves. And IT firms continued to benefit from other businesses' investment in cost-cutting technology. There had also been a rise in the number of corporate transactions, and restructuring work, supporting legal and accountancy services.

Manufacturing

Manufacturing output for the domestic market continued to expand at a moderate pace. This was often driven by final demand from abroad, particularly for firms in the automotive, aerospace, and pharmaceutical supply chains. Food manufacturing remained an area of resilience, with suppliers of unbranded goods tending to do particularly well. And there were also some reports of an improvement in activity from suppliers of household and garden products. Manufacturing for domestic construction was typically very weak, however, and firms were sometimes reorienting themselves to target foreign markets. Suppliers to the public sector also often reported that conditions were challenging.

Construction

The Agents' score for construction output growth indicated that there had been a further contraction in activity compared with a year earlier, in large part due to declining work for the public sector, and small firms were often finding conditions particularly difficult. See the box on page 5 for a discussion of the results of a survey conducted by the Agents on recent activity in the construction sector. Conditions were typically better in London and the South East, compared with the rest of the country, particularly for commercial property. But there had been a small improvement in house building across a number of regions. Retail refurbishments were also providing support to the level of activity, although the rate of new store openings had slowed. Tender prices remained under considerable downward pressure, reflecting significant spare capacity in the industry as a whole, and there had been a pickup in insolvencies in the sector.

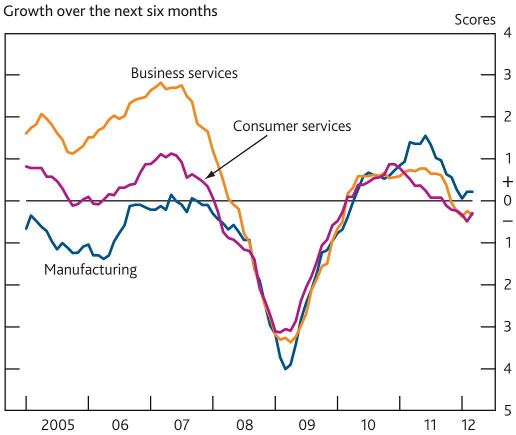
Credit conditions

For firms with strong balance sheets, credit was normally available on reasonable terms. But for some businesses there had been a rise in the interest rate spreads charged on loans over the past few months, and fees were also reported to have increased. And it had become harder to secure long-term funding from banks, increasing the frequency of renegotiations and attendant charges. Some firms had responded to tighter credit conditions by seeking alternative forms of finance, from wealthy individuals or institutional investors, such as pension funds. Other businesses were actively paying down debt, or were focused on generating cash, preferring to finance investment internally, rather than through borrowing, even if it tended to slow the pace of investment. Some smaller firms continued to report that they were unable to obtain credit at any cost and were seeing overdrafts withdrawn. It also remained difficult for construction firms to secure credit, and there were suggestions that lenders had become more willing to foreclose on non-performing commercial property lending.

Employment

Private sector employment was expected to be broadly unchanged over the next six months (**Chart 2**). Manufacturing firms typically planned to meet future demand growth through rising productivity. But some were taking apprentices on to address long-standing skills gaps, while further redundancies were expected among firms supplying goods for domestic households, as persistently weak demand and low margins spurred further reductions in costs. In business services, recruitment plans were also flat. Again, there was a moderate amount of hiring of junior staff under way to accommodate growth in the medium term. But some businesses planned to lower headcount, having revised down their expectations for growth. Mergers of small, local, professional and financial services practices were also expected to lead to some job losses. In retail, some larger chains continued to take on staff, but that was expected to be offset by store closures and insolvencies elsewhere. Where headcount was rising, that was often with a view to create flexibility in the workforce, with total hours being held constant overall.

Chart 2 Employment intentions

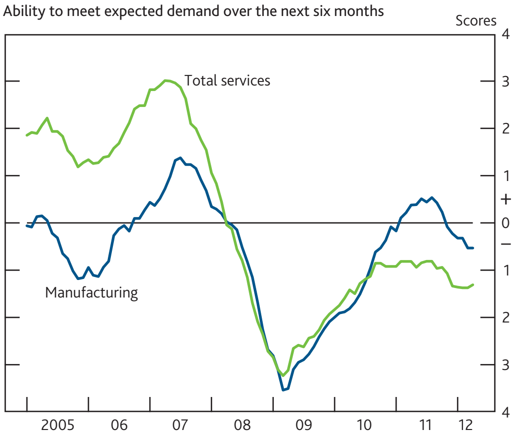


Capacity utilisation

In manufacturing, capacity utilisation was a little below normal, with most firms able to meet expected changes in demand comfortably (**Chart 3**). Exporters tended to have rather less slack than firms supplying the domestic market, however, and were sometimes declining UK orders in favour of higher margin overseas business. In the service sector, contacts tended to report relatively higher levels of spare capacity. But in growth areas, such as IT, firms often reported that they had little spare capacity. In some industries, such as food production and haulage, consolidation through mergers and firm exits had removed an element of spare capacity. And more small businesses were expected to close, as the fatigue caused by persistently difficult trading conditions set in among owners. In some services with large fixed assets, businesses were attempting to reorganise physical capital, for instance by reconfiguring retail units in shopping centres, to attract higher margin custom. Retailers themselves often had considerable spare capacity, despite already being at minimum staffing levels, and more store closures were expected.

Chart 3 Capacity utilisation

Ability to meet expected demand over the next six months



Costs and prices

Labour costs

Labour cost growth remained fairly modest. Private sector settlements continued to be around 2% or 3%, with awards tending to be a little higher in manufacturing than services. In the construction and retail sectors pay freezes were common, or there had been increases in line with the national minimum wage. There were generally few signs of upward pressure on pay from staff, except among some unionised workforces. And there were ongoing steps by employers to move away from inflation indexation and across-the-board settlements, towards more performance-based awards, and targeted increases to retain key skills, while keeping down overall staff costs. Employers were also seeking to limit increases in labour costs in other ways, for instance, by reducing the increments for professional qualification, or removing the premium attached to overtime.

Non-labour costs

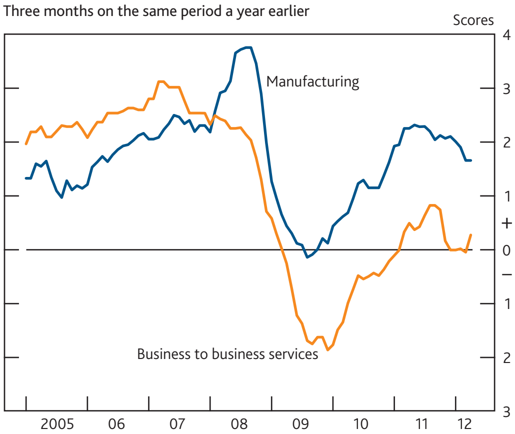
Materials cost inflation remained around its historical average, as the pace of increase in the prices of various commodities had slowed. But the past rise in the price of oil was reported to be feeding through to higher haulage and shipping charges, along with the prices of oil-based materials, and energy-intensive products. Import prices had also continued to rise at a steady pace. The recent appreciation of sterling had lowered the price of imports somewhat, and the cost of some electronic components affected by flooding in Thailand had stabilised. Offsetting these influences were rapid increases in wage costs in some emerging market economies.

Output prices

Output prices continued to rise at a moderate pace reflecting some pass-through of increases in costs (**Chart 4**). Pass-through tended to be greatest among suppliers of niche goods and services, or where contracts included escalator clauses, which allowed increases in input costs to be passed on to customers. And there had been a rise in the frequency of reports of efforts made to protect margins by turning down lower-priced jobs. For instance, some food producers were now prepared to lose supermarket business rather than continue to participate in promotional activity. In contrast, for businesses selling into sectors where demand was weak it remained difficult to secure price increases. This was the case for suppliers of cleaning services, and standardised legal and accountancy practices, for example. But some firms were trying to offset downward pressure on prices by re-engineering products to cut costs.

Chart 4 Output price inflation

Three months on the same period a year earlier



Consumer prices

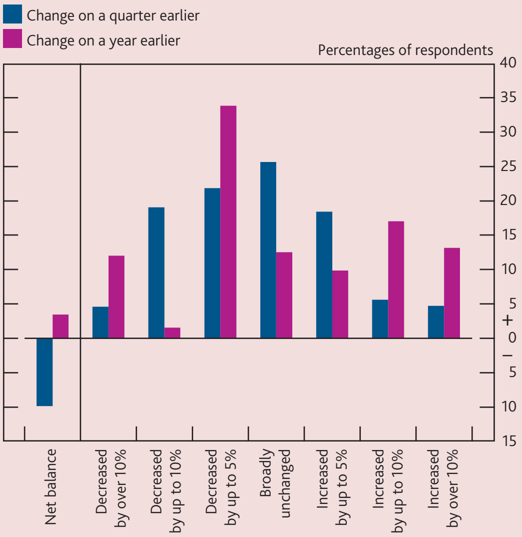
Consumer goods price inflation remained elevated, in part due to higher fuel prices, along with rising costs of production and increases in the price of imported finished goods. And while discounting and bundled promotions continued to be widespread, unit prices were often being marked up. Inflation in consumer services was also fairly high, in large part due to the indexation of a number of essential services to measures of official inflation over the past year, for instance in public transport and social housing rents. Upward pressure on private rents was thought to be abating, however, as the supply of rental property picked up, and because demand was beginning to be choked off by higher charges in some areas. Non-essential service providers typically had relatively little pricing power, meanwhile, tending to restrain the pace of inflation.

Agents' survey on construction

According to ONS non seasonally adjusted monthly data, construction output was very weak during the past winter. The Agents conducted a survey to try to get another read on the strength of activity in the sector. The survey asked contacts about changes in output in 2012 Q1 compared with the previous quarter and the previous year. And contacts were also asked about the length of shutdown periods during the winter months. 152 firms responded, and accounted for around a fifth of the sector by turnover.

Weighting the results by turnover, around a quarter of respondents reported that the volume of output in 2012 Q1 was flat compared with a quarter earlier, and more companies reported that output was falling than rising (**Chart A**). Overall, a net balance of 10% of firms reported that turnover had fallen, suggesting that there had been a modest decline in output compared with a quarter earlier. This appeared rather less weak than the fall in the official data.

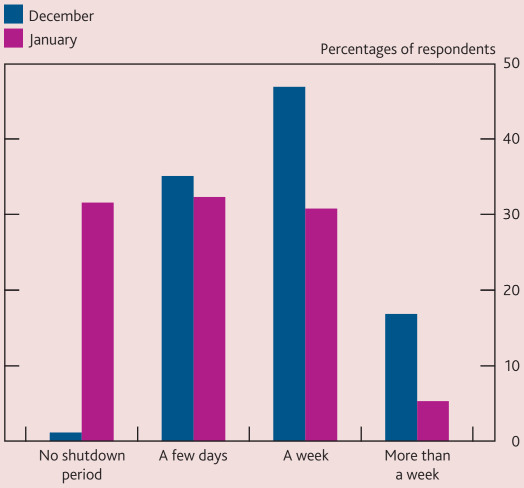
Chart A Change in output in 2012 Q1 compared with a quarter earlier and a year earlier



When responding to the question about changes in activity in 2012 Q1 compared with the previous year, there was a small positive net balance of responses (**Chart A**). But this was largely due to house builders, which tended to report much better annual rates of growth than the sample as a whole. Broadly, the survey results suggested that activity had been flat over the course of the past year. Again, this indicated that activity may have been a little stronger than in the official data.

The majority of respondents reported that they normally shut down for up to a week in both December and January (**Chart B**). That suggested that it might be reasonable to expect a fairly sizable decline in the level of activity over the course of the winter.

Chart B 'Normal' seasonal shutdown periods during winter months



The vast majority of firms reported that in both December 2011 and January 2012, their shutdown periods had been the same as usual (**Chart C**). Perhaps surprisingly, however, given the extremely bad weather conditions in December 2010, firms reported that the shutdown period then had also been the same as usual. But there may have been additional days lost, which the survey did not capture, as it asked only about the 'normal' shutdown period. And it appears that for many firms, while sites remained open during the bad weather, much less work could be completed. Also, at the time, a few contacts had reported that the bad weather coincided with the usual shutdown period, so had caused little disruption.

Chart C Shutdown periods over the most recent winter